

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
ABEX CORPORATION	:	DETERMINATION
	:	DTA NO. 807575
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Years 1977	:	
through 1985.	:	

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Petitioner, Abex Corporation, c/o Whitman Corporation, 111 East Wacker Drive, Chicago, Illinois 60601, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1977 through 1985.

On February 20, 1991 and March 4, 1991, respectively, petitioner by its representative, John F. Palmer, and the Division of Taxation by William F. Collins, Esq. (James Della Porta, Esq., of counsel) consented to have the instant controversy determined on submission without hearing. Documentary evidence was submitted by the Division on March 22, 1991. Petitioner submitted a brief and an affidavit on May 23, 1991. The Division submitted a brief on June 13, 1991. Petitioner submitted a reply brief on July 2, 1991. Petitioner was represented by William F. Werth, Director - Tax Audits, Whitman Corporation. The Division of Taxation was represented by William F. Collins, Esq. (James Della Porta, Esq., of counsel). After review of the entire record, Thomas C. Sacca, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether petitioner, in computing its entire net income for the purposes of Article 9-A franchise tax, is required pursuant to Tax Law§ 208.9(b)(5), as effective for the years at issue, to add back to Federal taxable income interest paid to its parent corporation.

II. Whether petitioner is entitled to carry back to 1979 a net operating loss arising from the year 1982, or in the alternative, to carry forward the 1982 loss to the years 1983, 1984 or 1985.

FINDINGS OF FACT

Petitioner, Abex Corporation ("Abex"), is a diversified manufacturer which operates on a divisional basis. Its corporate headquarters moved from New York City to Stamford, Connecticut in 1984 and then to Boston, Massachusetts in 1986. Petitioner is a wholly-owned subsidiary of IC Products Company ("Products") which in turn is a wholly-owned subsidiary of IC Industries, Inc. ("Company"). The Company's name was changed to the Whitman Corporation on December 1, 1988.

During the tax years involved, Abex deducted on its New York franchise tax reports interest expense on loans provided by IC Commercial Paper, Inc. ("Commercial Paper") as follows:

<u>Year</u>	<u>Amount</u>
1983	\$5,242,180.00
1984	5,830,556.00
1985	4,817,030.00

Commercial Paper is a subsidiary of the investment banking firm, Merrill Lynch Capital Markets, Inc., and is unrelated to petitioner, the Company or Products.

The financial arrangement which was the basis of these payments was entered into on March 15, 1983, and is entitled " Designated Subsidiary Loan Agreement". The parties to the agreement were Commercial Paper, the Company and Abex. The purpose of the arrangement was to permit the operating subsidiaries of the Company (which, in addition to Abex, included Midas International Corporation, an automobile exhaust system franchisor headquartered in Chicago, Illinois; Pepsi-Cola Bottlers, Inc., a soft drink bottler also headquartered in Chicago; and Pet Incorporated, a specialty foods company headquartered in St. Louis, Missouri) to obtain current financing for their operations from the commercial paper market. The Company, being a holding company, had no operations and therefore no need for such financing.

Neither the Company nor the individual operating subsidiaries possessed a sufficient credit rating to directly access the commercial paper market. A rating of "A-1" or "A-2" from Standard and Poor's Corporation would normally be required to access such market. However,

with the assistance of Merrill Lynch, various commercial banks and the combined assets of Products, Commercial Paper was established and provided with a stand-by letter of credit which enabled it to obtain an "A-1" credit rating.

Pursuant to the Designated Subsidiary Loan Agreement, Commercial Paper would sell its short-term notes in the commercial paper market and loan the proceeds to the operating subsidiaries (including Abex) to enable them to purchase the merchandise necessary to carry on their businesses. To more efficiently handle the loan repayments, the Company assumed the obligations of the operating subsidiaries to Commercial Paper, collected principal and interest payments from each operating subsidiary and used them to pay Commercial Paper. As a result of the Company assuming the obligations of Abex with respect to the loan from Commercial Paper, Abex was released from all liability to Commercial Paper with respect to such loan.

The Company did not directly own the stock of the operating subsidiaries, all of which was owned by Products. Products was a holding company formed to sell long-term debt. According to the loan agreement, the operating subsidiaries made their payments to Products, which in turn made payment to the Company. The loan agreement further provided that Abex agreed to be indebted to Products in an amount equal to all loans made by Commercial Paper to Abex and assumed by the Company. Under the agreement, Products was obligated to forward the payments from Abex to the Company, which was obligated to use the payments from Products to pay Commercial Paper the Company's obligations in respect of the loans made to Abex and assumed by the Company.

The Division of Taxation, during an audit of Abex, added back to petitioner's entire net income 90% of the interest paid to Products that was related to the Commercial Paper loans. In addition, the Division discovered on audit that Abex had unreported Federal audit adjustments for 1977, 1978 and 1979. The auditor increased Abex's entire net income for these years by the amount of the Federal audit adjustments, resulting in additional tax due for each of the three years.

During the course of the audit, Abex filed claims for credit or refund of corporation tax

paid, form CT-8, for the years 1979, 1980 and 1981. The refund claims were filed on December 24, 1987. The refunds were based upon net operating loss carrybacks from the years 1982, 1983 and 1984. On audit, the Division disallowed the 1982 loss carryback on the basis that the statute of limitations for filing such claim had expired. The auditor carried back the 1983 loss to 1980. As a result of various audit adjustments not at issue in this matter, the loss for 1984 was changed to income, resulting in no carryback for this year.

As a result of the audit, the Division determined the following amounts of additional tax, penalty and interest (computed to September 14, 1989) due:

<u>Period Ended</u>	<u>Tax</u>	<u>Interest</u>	<u>Penalty</u>
12/31/77	\$ 420.00	\$ 817.00	\$ 263.00
12/31/78	618.00	1,106.00	387.00
12/31/79	14,974.00	24,481.00	7,832.00
12/31/80	(47,622.00)	(70,470.00)	0.00
12/31/81	0.00	0.00	0.00
12/31/82	0.00	0.00	0.00
12/31/83	0.00	0.00	0.00
12/31/84	1,215.00	648.00	0.00
12/31/84	33,644.00	17,942.00	0.00
12/31/85	2,596.00	945.00	0.00
12/31/85	72,650.00	26,441.00	0.00

Penalties were asserted for the years 1977, 1978 and 1979 based on Tax Law § 1085(a)(1), (2) and (k), for petitioner's failure to file a return, failure to pay tax shown on a return and for petitioner's substantial understatement of tax liability.

On September 14, 1989, the Division issued seven notices of deficiency under Article 9-A to Abex for the years 1977, 1978, 1979, 1984 (2) and 1985 (2), asserting total tax due of \$78,495.00, plus penalty and interest.

The Company and its affiliated corporations, including Abex, filed a consolidated Federal income tax return for the year 1982. The Company and its affiliated corporations elected to relinquish the entire carryback period with respect to its net operating loss for the taxable year ended December 31, 1982, pursuant to Internal Revenue Code § 172(b)(3). Abex did not introduce any evidence into the record of this matter as to the amount of the losses that were claimed to have been carried forward from 1982 to 1983, 1984 or 1985 for Federal tax

purposes.

### SUMMARY OF THE PARTIES' POSITIONS

Petitioner contends that it did not incur interest on an indebtedness from its parent corporation (IC Products Co.) as the loan was from IC Commercial Paper, Inc., a non-affiliated entity. In the alternative, petitioner claims that its parent and grandparent corporation merely acted as conduits in the payment of interest from Abex to Commercial Paper.

Petitioner contends the Division should have addressed the 1982 loss as it impacts on the determination of the correct amount of taxable income in another year at issue. Petitioner further claims that if the 1982 loss is not allowable as a carryback to 1979, it should be afforded carryforward treatment to the years 1983, 1984 and 1985 as was allowable for Federal income tax purposes.

The Division contends that Tax Law § 208.9(b)(5) mandates the addback of the interest expense as petitioner was obligated under the loan agreement to pay to Products the interest payments, and did, in fact, make such payments. In addition, the Division claims that petitioner does not meet the requirements of the conduit exception.

As for the 1982 net operating loss, the Division contends that the claim for refund was untimely filed. The Division's position is that since a net operating loss for New York State purposes is the same as that which is allowable for Federal tax purposes, and the time to file a Federal claim for refund expired prior to the filing of the New York State refund claim, petitioner is not entitled to carry back the 1982 loss to 1979.

### CONCLUSIONS OF LAW

A. Tax Law § 208.9(b)(5) states, in pertinent part:

"Entire net income shall be determined without the exclusion, deduction or credit of:

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(5) ninety per centum of interest on indebtedness directly or indirectly owed to any stockholder or shareholder (including subsidiaries of a corporate stockholder or shareholder), or members of the immediate family of an individual stockholder or shareholder, owning in the aggregate in excess of five per centum of the issued capital stock of the taxpayer...."

The modification set forth above disallows 90% of a corporation's Federal deduction for interest paid or accrued on indebtedness to a "shareholder" owning more than 5% of the stock of that company, with several exceptions inapplicable in this case.

The language of the statute unambiguously provides for the addback of 90% of any interest paid on indebtedness owed to related shareholder- creditors in computing the entire net income on which the State's franchise tax is based. Related creditors are clearly defined to include a corporate stockholder, including subsidiaries of a corporate stockholder, owning in the aggregate more than 5% of the issued capital stock of the taxpayer (Tax Law § 208[9][b][5]). Under the Designated Subsidiary Loan Agreement entered into by the Company, Abex and Commercial Paper, Commercial Paper loaned money to Abex. At the time of the loan, the Company assumed the obligation to pay the principal and interest. In consideration for the Company's assumption, Abex acknowledged that it was indebted to Products and would pay principal and interest to Products. Consistent with the provisions of the agreement, petitioner made interest payments to Products, which wholly-owned Abex. Thus, petitioner's payments of interest to its parent falls within the situation in which Tax Law § 208.9(b)(5) mandates the addback requirement (Matter of Friesch-Groningsche Hypotheek Bank Realty Credit Corporation, Tax Appeals Tribunal, December 28, 1990; see also, Technical Services Bureau Memorandum TSB-M-83[24]C).

B. The Division had a long-standing policy of recognizing an exception to the addback requirement of section 208.9(b)(5). Where a "stockholder" of a corporation borrowed money from an unrelated source, and subsequently lent the borrowed funds to such corporation, some or all of the interest paid to such "stockholder" by that corporation was deemed to have been paid merely as a conduit, and the addback provisions of Tax Law § 208.9(b)(5) were not applied. Recognition of the conduit exception began in the 1950's and was originally limited to a finance company and its subsidiary. Over the years, the Division expanded the application of the theory to a larger number of transactions and specified criteria which had to be met by a taxpayer seeking the benefit of the Department's policy (see, Matter of Friesch-Groningsche

Hypotheek Bank Realty Credit Corporation, supra).

The criteria as outlined by the Department which had to be met in order to consider the "stockholder" to have acted as a mere conduit between the unrelated source of funds and the corporation were as follows:

- "1. The deduction for interest expense must be for indebtedness owed by the corporation to a 'stockholder'.
2. The corporation must demonstrate that at the time the indebtedness was incurred the 'stockholder's' financial standing allowed it to borrow funds at a lower rate of interest than that obtainable by the corporation.
3. The corporation must demonstrate that the funds loaned to it were borrowed by the 'stockholder' from an entity unrelated to either the 'stockholder' or the corporation, for the purpose of re-lending the funds to the corporation.
4. The corporation must demonstrate that, at about the time the loan was made, it was not under-capitalized and that the funds were needed to meet ordinary business expenses or working capital needs, and were not a substitute for an investment in the stock of the corporation." (See, MC Minerals Corp., Advisory Opinion [TSB-H-81(21)C].)

The result was that the corporation was allowed to deduct as interest expense an amount equivalent to the interest paid by the "stockholder" to the unrelated lender of the funds.

However, in its Technical Services Bureau memorandum (TSB-M-83[24]C), the Division changed its policy and rejected the "conduit theory" in the following manner:

"On several occasions in the past, taxpayers have requested a full deduction for such interest where it was found that a more than 5% shareholder of a corporation (usually a parent corporation) had borrowed money solely to re-lend to such corporation (usually a subsidiary corporation) so that the interest paid by such corporation to the shareholder was considered to have been 'passed through' the shareholder, as through a 'conduit', to the outside lender. Since such interest does not fall within the ambit of the exceptions to the add back rule, it must be added back pursuant to section 208.9(b)(5) of the Tax Law.

To the extent any prior publications of this Department are not in accord with the foregoing statements, they are overruled."

The Tax Appeals Tribunal held that the effective date of the Division's removal of the conduit principle as an exception to the interest addback requirement of Tax Law § 208.9(b)(5) was April 1, 1984 (Matter of Friesch-Groningsche Hypotheek Bank Realty Credit Corporation, supra). Therefore, the issue remains as to whether the transactions prior to April 1984 between petitioner and Products meet the criteria for exemption from the addback requirement.

C. The first criteria is met as Abex agreed to be indebted to Products, the entity which owns 100% of the stock of Abex. Petitioner's financial standing was such that it could not access the commercial paper market on its own. However, by using the combined assets of all the operating subsidiaries and Products' status as a seller of long-term debt, the Company was able to obtain financing from Commercial Paper, which obtained an A-1 credit rating and access to the commercial paper market. It is apparent that the holdings of Products enabled the Company to obtain a more favorable financial arrangement than Abex alone could have obtained. Thus, the second criteria has been met. As Commercial Paper was not related to the Company, Products or Abex, the third criteria has been met. The purpose of the loans was to finance specific types of merchandise, a current transaction, and to obtain current financing for the operations of the subsidiaries. Finally, it is noted that commercial paper (a short-term promissory note) is by its nature financing for current transactions as its due dates usually vary between 30 and 270 days. Therefore, all the criteria required by the Division have been satisfied. Although there was an additional step in the payment process between Abex and Commercial Paper, this does not defeat the application of the conduit theory to the facts presented herein, as the purpose of the theory is to look through the form of the transactions involved and to analyze its substance. To have the conduit theory defeated by such a strict adherence to the form of the transaction would be contrary to the theory's purpose. Thus, it is determined that Abex qualifies for the conduit theory for the period prior to April 1, 1984.

D. Tax Law § 1089(g) provides as follows:

"Jurisdiction over other years. -- The tax commission shall consider such facts with relation to the taxes for other years as may be necessary correctly to determine the tax for the taxable year, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid."<sup>1</sup>

Section 1089(g) is similar to section 6214(b) of the Internal Revenue Code. Accordingly,

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Internal Revenue Code § 6214(b) authorizes the Tax Court of the United States to examine the validity of deductions resulting from losses in years for which the statute of limitations has expired, when redetermining income for other tax years under its consideration.



Federal case law may be reviewed for guidance.

"It is well settled that [pursuant to section 6214(b)] we may determine the correct amount of taxable income or net operating loss for a year not in issue (whether or not the assessment of a deficiency for that year is barred) as a preliminary step in determining the correct amount of a net operating loss carryover to a taxable year in issue." (Lone Manor Farms, Inc. v. Commr., 61 TC 436, 440 [1974], affd 510 F2d 970 [3d Cir 1975]; see, Matter of Davies Lake Hotel, Inc., Tax Appeals Tribunal, January 20, 1989.)

As the years to which Abex wishes to carry back or carry forward the loss are in issue in this matter, facts relating to the taxes for such years at issue may be considered, including the amount of the net operating loss from the year 1982.

E. Tax Law § 208.9(f) provides, in part, as follows:

"A net operating loss deduction shall be allowed which shall be presumably the same as the net operating loss deduction allowed under section one hundred seventy-two of the internal revenue code of nineteen hundred fifty-four....

\* \* \*

(3) such deduction shall not exceed the deduction for the taxable year allowable under section one hundred seventy-two of the internal revenue code...." (Tax Law § 208.9[f]; see also, 20 NYCRR 3-8.1.)

The regulations and case law establish that the amount of the net operating loss deduction for State purposes cannot exceed the amount deducted on the Federal tax return for the corresponding year (20 NYCRR 3-8.2[d]; Matter of Royal Indemnity Co. v. Tax Appeals Tribunal, 75 NY2d 75; Matter of Telmar Communications Corp. v. Procaccino, 48 AD2d 189; Matter of Lehigh Valley Industries, Inc., Tax Appeals Tribunal, May 5, 1988). Further, the source year of the net operating loss deducted on the State return must be the same as that of the net operating loss deducted on the Federal return (Matter of Lehigh Valley Industries, Inc., supra).

Since petitioner elected, pursuant to Internal Revenue Code § 172(b)(3), to relinquish the entire carryback period with respect to its net operating loss for the taxable year ended December 31, 1982 for Federal tax purposes, petitioner is not entitled to carry back the 1982 loss for New York State tax purposes. In addition, since petitioner did not prove the amount of the net operating loss deduction claimed by it for Federal tax purposes for 1983, 1984 or 1985,

or the source year of such loss, it is not entitled to carry forward the 1982 loss for New York State tax purposes (Matter of Fazal Ahmad, P.C., Tax Appeals Tribunal, August 8, 1991; Matter of Alvin Gottesman, Tax Appeals Tribunal, August 25, 1988).

F. The petition of Abex Corporation is hereby granted to the extent set forth in Conclusion of Law "C"; the notices of deficiency issued on September 14, 1989 are to be modified accordingly. In all other respects, the petition and the claim for refund concerning the loss year 1982 are denied.

DATED: Troy, New York

12/27/91

ADMINISTRATIVE LAW JUDGE